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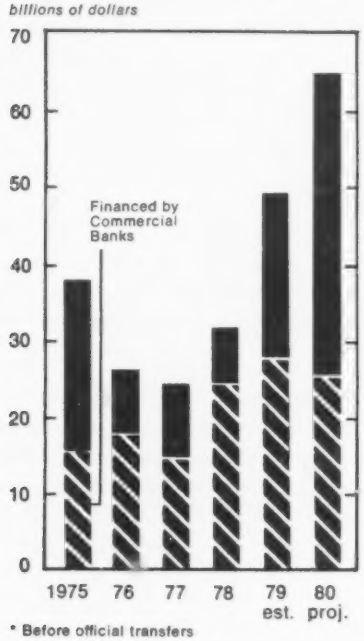
Growth Slowdown in the Non-Oil LDCs

There has been much loose talk in recent months about whether "recycling is going to work for the non-oil LDCs this time around." Stated this way—with the implication of deficits too large to be financed—the question has no meaning. A deficit that cannot be funded cannot exist. Rather, the appropriate questions are: First, whether countries whose future growth is now limited by tighter foreign-borrowing constraints will recognize the dimensions of these limitations and adjust their policies accordingly—or whether they will postpone adjustment until forced by disruption of capital flows; and, second, whether the anticipated growth performance of the developing economies implied by these new constraints is acceptable to potential suppliers of official aid or credit.

Current-account deficits* of non-OPEC LDCs



* Before official transfers

These questions must be posed on a country-by-country basis. The recent unsettling events in the Middle East and increased pessimism with respect to the long-term trend in oil prices have probably resulted in some generalized reduction in the willingness of banks to make foreign loans. However, the expected tightening in overseas bank lending is primarily a matter of changes in bank perceptions of the debt-service capability of particular countries—or the worrisome increase in the ratios of certain developing-country debts to total bank capital.

A survey of the countries whose external-debt positions and long-run growth objectives suggest a particular vulnerability to external funding constraints indicates that most are already in the process of significant adjustment. In some cases, however, much more needs to be done. Thus, although problems will undoubtedly emerge, there is currently no basis for the prediction that the adjustment process is being so generally delayed in the non-oil LDCs that something approaching a synchronized interruption of debt service will result.

The reduction in growth rates implied by this scenario is severe, however, particularly in the export-oriented "newly industrialized economies." Growth over the next year or two in these countries will probably be no more than half the rate achieved in recent years. The slowdown in the so-called "middle-income" developing economies will be less pronounced but still significant for the vast majority. Unlike the world recession of 1974-75, the non-oil developing nations will be full-fledged partners with the developed countries in the forthcoming world economic slowdown.

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Austrian growth forecasts revised downward, but inflation to accelerate.

Since the end of 1978, Austria has lost about $1.5 billion in foreign-exchange reserves as a result of rising German interest rates. To protect the schilling, which is effectively tied to the German mark, Austria's central bank has adopted a more restrictive monetary policy. The basic discount rate was raised 1.5 percentage points to 5.25%; the supplementary discount rate (applicable to the last 30% of bank discount quotas) was boosted to 6.25%; and the penalty rate for banks failing to satisfy reserve requirements was doubled to five percentage points above the basic discount rate. At the same time, current-account-balance prospects are constrained by weak real growth in Germany and higher oil prices. The current-account deficit is forecast to widen to 31 billion schillings from 25 billion in 1979. As for real GDP growth, forecasts have been revised down to 2.2%-2.5%, after 5% growth in 1979, while the inflation rate is expected to rise to an annual average of 4.8% in 1980, versus 3.6% last year.

Norway striving to enhance international competitiveness.

Norwegian economic growth is set to accelerate in 1980, stimulated by the country's oil and shipping sectors, which should contribute some 2% to GDP growth. Progress in these two industries will also sustain the steady improvement in the current-account balance, and help pare the current-account deficit to about $1 billion from $1.5 billion in 1979. With the outlook for traditional manufacturing industries dimmed by slowdowns in the economies of major trading partners, Norway's economic policy is now geared to enhancing the international competitiveness of traditional mainland industries. The system of selective supports for individual firms is being dismantled in favor of more generalized policy measures. But perhaps most critical is the outcome of the 1980 wage negotiations and prospects for inflation. September 1978 marked the beginning of a period of very restrictive wage and price controls, which saw the rate of increase in wages drop to about 4.75% and the rise in consumer prices to 4.8% over the course of 1979. The Government hopes that a continuation of price controls, plus reduced support for industry, will produce lower wage settlements and curb inflation.

Inflation-control a problem for Mexico's booming economy.

Mexico led the major Latin American economies in real GDP growth last year, posting an impressive 8% gain. Spurred on by substantial rises in oil output to about 2 million barrels per day as of end-1979, Mexico's industrial and construction sectors progressed vigorously. Only agriculture, troubled by drought conditions, failed to share in the overall rapid growth. This rapid demand expansion, however, has accelerated inflation; the average 1979 retail price index was up 18% over 1978. The strong economic advance is expected to continue in 1980, but inflationary pressures will mount. A new value-added tax is estimated to add 3% to inflation this year, while agreement has been reached to allow a 21.5% increase in the average national minimum wage during 1980, roughly in line with anticipated inflation. To slow recent large rises in the money supply and inflation, the central bank has raised minimum reserve requirements for commercial banks, but controlling inflation will be difficult in the face of an expansive fiscal policy and real growth of more than 7%.

Gold boom a boon to South African economy.

The sharp run-up in gold prices will have a significant effect on South Africa's economy in 1980. In the domestic sector, treasury revenue from gold for fiscal 1979/80 (ending June 30) will probably reach $2 billion, as against the budgeted $900 million. This added revenue will enable the Government to meet its commitment to encourage private-sector growth. Tax cuts of 5%-10% for individual taxpayers will very likely be included in the upcoming March budget, in addition to tax incentives to stimulate private fixed investment. The Government may also abolish the loan levy and the 7.5% import surcharge. Removal of the latter would lower the rate of inflation, which is expected to reach 15% this year, up from 13.5% in 1979. Some of the revenue overflow may also be directed to capital projects serving the black community. On the external front, anticipated higher imports associated with accelerating growth will reduce the $4-billion current-account surplus of 1979; but thanks to increased gold earnings, the surplus should

still remain at more than $2 billion this year, even assuming a conservative $400 per-ounce average gold price in 1980.

Japanese economy to weaken, but exports will revive.

Japan's economy is set for a slowdown in fiscal 1980/81 (beginning April 1). Consumer expenditures will continue to decline, owing to rising inflation and relatively small wage increases. And growth in private investment, rising about 15% in the current fiscal year in nominal terms, is expected to fall to some 7% next year as a result of declining corporate profits, high interest rates, and relatively restrictive monetary policy. In addition, government expenditures are slated to rise by a conservative 10.3%, the lowest growth rate in twenty years, while public loan and investment programs are estimated to increase a nominal 8%—or not at all in real terms. The one bright spot is exports. Export volume is likely to advance 8%-9% because of increased price competitiveness stemming from the yen's depreciation in 1979. Moreover, the domestic slowdown is likely to fuel a renewed export drive; the contribution of exports to GDP is projected to rise to 30% from 10% in FY 1979/80. Overall, real growth is expected to fall from this fiscal year's estimated rate of 6% to about 4% in FY 1980/81.

Singapore hopes for a second industrial revolution.

Singapore's economy is undergoing fundamental change to better position it to meet the economic challenges of the 1980s. The Government estimates that of the 7% average annual growth achieved between 1974 and 1979, productivity growth accounted for only 3%. Labor force growth made up the remaining 4%, 2.5% of which derived from neighboring ASEAN countries. Given Singapore's delicate population and communal balance, this heavy dependence on labor—particularly foreign—was regarded as unhealthy. Accordingly, the Government adopted a new industrial plan in 1979 aimed at enhancing productivity. The plan consists of a high-wage policy; upgrading the technology embodied in labor; and providing added incentives for capital and technology transfer from abroad. The strategy is expected to minimize competition with Singapore's less developed neighbors, while maximizing the complementarity of economic structures. If the plan is executed with minimal distortion to the socioeconomic framework, the official average annual growth target of 8% for the 1980s may be achieved.

Turkey steps up austerity.

With November consumer prices 75% above their year-earlier levels, Turkey's new government moved to announce further austerity measures, despite real GDP growth of less than 1% in 1979. The lira was devalued from 47.1 to 70 per U.S. dollar, energy prices will be increased between 44% and 100%, and prices for the products of the nationalized industries will be boosted. To moderate the inflationary impact of the devaluation, the stamp duty on imports will be cut sharply. Finally, regulations on foreign direct investment are being liberalized. The economy did experience improvement on the external front in 1979. The current-account deficit was $1.06 billion, down from $1.33 billion in 1978, and Turkey managed to reschedule some $3 billion in foreign debt. In 1980, however, the current-account gap is expected to exceed $1.8 billion. Total imports are likely to hit $7 billion, with oil imports alone about $4 billion. Export earnings, on the other hand, are officially forecast to reach only $3.5 billion, at best. With Turkey due to repay some $860 million in foreign debt this year, total new foreign-exchange needs will exceed $2.6 billion, as against $1.8 billion raised last year.

Sugar prices to remain firm this year.

World sugar prices have recently risen to nearly 20¢ per pound from an average of 8.85¢ in August, fueled by a fundamental shift in the supply/demand balance. World production for 1979/80 is now projected at 87.7 million metric tons, down almost 4% from 1978/79, and this, coupled with an expected rise in consumption, should result in a sharp drop in world sugar stocks this year following seven years of steady increase. An even sharper decline in stocks is possible in 1980/81. Thus, although prices are near levels that can trigger release of part of the buffer stock under the International Sugar Agreement recently ratified by the United States, and although speculative elements in the market may produce a near-term correction, sugar prices are expected to remain strong this year.

Taxes, Arms Spending, and Inflation

The budget proposed by President Carter for fiscal year 1981 sounds a lot like an incumbent politician's dream come true. Defense spending is boosted in response to the perceived new Soviet threat, while domestic spending for income security, agriculture, housing, and transportation is also higher. And the budget can still be termed "anti-inflationary", since the $16-billion projected deficit is substantially lower than the (upward-revised) $40-billion shortfall for FY 1980. Moreover, this reduction in the deficit is expected to occur despite the Administration's forecast of a slight decline in business activity and rising unemployment that will cut into receipts and raise expenditures.

The solution to this apparent paradox is higher taxes, but from either previously enacted bills or sources not directly affecting voters. Both the base wage and the rate for Social Security are scheduled to rise in 1981 by previous congressional action. These changes are estimated to increase revenues $15 billion above FY 1980. Furthermore, as nominal incomes rise to keep pace with continuing high inflation, more taxpayers are pushed into higher income tax brackets. So, barring any tax reduction, personal income taxes will still rise about 1½ times faster than personal income. For FY 1981, this "inflation tax" will generate another $15 billion or so. In addition, the net receipts from the new excise tax on domestically produced crude oil—the so-called "windfall-profits" tax—will add another $14 billion, and an accelerated schedule for tax payments will yield still another $5 billion. Overall, tax receipts are projected to grow 14½%. Expenditures, on the other hand, are scheduled to rise only 9¾%. Defense spending is projected to increase more than 12%, while other outlays are budgeted to rise by only 8½%.

Several economic analysts have expressed the concern that increased defense spending will worsen the inflation outlook. They argue that defense contractors will step up their spending for some materials, machinery, and skilled personnel currently in short supply, adding to existing price pressures. This concern, however, appears premature. During the aerospace slump in the early 1970s, many defense contractors suddenly found themselves with excess capacity. Some have since shown a preference for more stable commercial orders. As a result, any capacity expansion is likely to be cautious until the Federal commitment to higher defense spending seems lasting or until additional investment incentives are introduced.

In the event of the much more rapid military buildup that some analysts fear is necessary, the "guns vs. butter" decisions would be much harder to make. In the absence of an explicit increase in taxes or cuts in nondefense spending to pay for the higher military expenditures, the deficit would swell. The Federal Reserve might then find it more difficult to avoid accommodating the larger deficits with monetary expansion.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1978		BALANC				
		3-months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	us cr lions
Austria	Economic growth set to slow sharply in 1980 from more than 5% in 1979.	Sept.	+ 9.1%	58.1	+ 1.5%	Nov.	3,634	− 17.6%	2.3	
Belgium	Economic growth to weaken; large public-sector deficit limits scope for reflation.	Sept.	+ 4.5%	96.1	+ 1.6%	Nov.	6,259	+ 59.3%	1.3	
Britain	Recession expected in 1980, despite small recovery at year-end 1979.	Sept.	+ 1.2%	308.2	+ 3.2%	Nov.	19,371	+ 22.8%	2.4	
Denmark	Economy headed for recession as a result of restrictive fiscal policies.	Sept.	+ 3.7%	55.5	+ 1.0%	Nov.	3,124.	+ 7.6%	2.1	
Finland	GDP still growing rapidly in the wake of 1979 boom.	Sept.	+ 9.2%	32.2	+ 2.5%	Nov.	1,439	+ 39.7%	1.7	
France	Industrial orders remain strong, but consumer surveys indicate weakening confidence.	Sept.	+ 7.2%	470.5	+ 3.3%	Oct.	16,483	+ 91.8%	1.9	
Germany	Growth forecast for 1980 being revised downward; tough wage round in progress.	Oct.	+ 4.2%	639.2	+ 3.1%	Nov.	49,032	+ 4.3%	3.9	
Ireland	Government's ambitious growth targets now being scaled down.	Mar.	+ 6.7%	12.2	+ 7.0%	Nov.	2,092	− 18.9%	2.7	
Italy	Economy set to slow sharply from 4%+ real growth in 1979; inflation rate approaching 20%.	Sept.	+ 7.1%	237.0	+ 2.6%	Nov.	18,576	+ 78.4%	3.1	
Netherlands	Export- and investment-led slowdown forecast for 1980; inflation likely to rise to 6%.	Nov.	+ 2.2%	130.5	+ 2.5%	Nov.	7,506	+ 66.9%	1.4	
Norway	Unlike most European countries, economic growth will rise in 1980—because of oil.	Oct.	+ 5.8%	39.7	+ 3.5%	Nov.	4,366	+ 72.1%	4.0	
Portugal	Confidence improves following Carneiro election victory.	Apr.	+ 7.0%	18.3	+ 3.2%	Oct.	1,141	+ 25.4%	2.5	
Spain	Economy slowing down; 1.5% growth expected in 1980.	June	+ 2.5%	141.2	+ 2.9%	Oct.	13,172	+ 32.7%	6.9	
Sweden	Government planning public spending cuts, but GDP growth still expected to approach 3%.	Sept.	+ 9.6%	87.2	+ 2.8%	Nov.	3,491	− 15.9%	1.5	
Switzerland	Growth prospects favorable for first half of year.	June	− 2.7%	84.4	+ 0.9%	Nov.	13,962	− 4.8%	5.8	
Turkey	IMF-imposed credit and spending ceilings adhered to; further austerity measures forthcoming.	June	0	48.7	+ 3.2%	Oct.	895	− 18.9%	2.2	
Canada	Indications of less consumer confidence in economic outlook; real GDP growth of 1% forecast.	Sept.	+ 5.1%	206.0	+ 3.4%	Nov.	2,966	− 15.5%	0.7	
United States	Higher energy prices push already-fragile economy closer to recession.	Dec.	+ 0.9%	2,098.6	+ 4.0%	Nov.	8,149	+ 28.8%	0.5	

A New Look at Monetary Policy

Monetary policy will be undergoing renewed scrutiny in coming weeks. The upcoming meeting of the Federal Open Market Committee, scheduled for February 5, is expected to furnish new insights into the strategy of monetary policy for 1980. And the regular congressional testimony by Federal Reserve Chairman Volcker, slated for mid-February, will provide extended discussion of current policies and their links to pressing economic questions.

Three issues will be receiving particular attention. First, it is widely anticipated that the Federal Reserve will announce a redefinition of certain monetary aggregates—ranging from M_1 and other "Ms" through broad measures of liquid assets. One uncertainty in this regard will be the extent to which "new" aggregates are a more accurate indication of developments in the economy.

The second issue, an extension of the first, deals with what new measures of control may be undertaken and how. Intuitively, there is no reason to believe newly defined aggregates will be easier to control than the old ones, given present reserve requirements and operating procedures. In fact, control may be more difficult. Moreover, the fourth-quarter 1979 experience with monetary aggregates was not a true test of the Fed's resolve to face the tactical consequences of greater emphasis on the growth of monetary aggregates. The reason for this is that fourth-quarter growth of M_1 had only to fall within a range of roughly—3% to 9% in order to be consistent with the revised 1979 growth target of 3%-6%.

The third issue relates to the role of interest rates as a policy variable. While the Fed curbed its efforts to moderate short-run variability in the Federal funds rate in its policy moves last October, it by no means abandoned interest rates as operating targets. At this stage of the cycle, when interpretation of monetary aggregates is more complex than usual, interest rates —relative to actual and expected inflation—play an important role as an indicator of policy. Under current inflation conditions, the recent Federal funds range of 12¾%-14% is about even with the Consumer Price Index and a bit higher than broader inflation measures. However, this level does not reflect tax effects. As a number of analysts have pointed out, on an *after-tax* basis, interest rates are well below the inflation rate. That is, in some cases rate levels are still low enough to constitute an incentive to incur new debt.

Uncertainty over the relative weights to be accorded interest rates and money growth as policy objectives will not be dispelled in February—and perhaps not until much later in 1980. There will come a time, however, when economic conditions (including money growth) will cause the Fed to change its Federal funds targets materially. In coming weeks, the market will be looking for new evidence regarding the Fed's reaction strategy.

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
f IMF t. mil- dollars	current influences on payments	12-month changes latest data	consumer prices	latest data	domestic credit	central bank rate January 30, 1980	exchange rate in U.S. dollars January 30, 1980	current monetary conditions	
0	Hard-schilling policy maintained, despite widening current-account gap.	Dec.	+ 4.7%	Sept.	+17.2%	5.25%	.0803	Discount rate raised to 5.25%.	Austria
0	Higher oil prices all but rule out a narrowing current-account gap.	Nov.	+ 5.3%	June	+14.5%	10.50%	.03540	Monetary conditions are restrictive.	Belgium
63	Current-account deficit narrowed somewhat in recent months.	Dec.	+17.2%	Oct.	+17.1%	17.00%	2.2635	£ strong due to high rates and bull market for govt. stocks.	Britain
0	Current-account deficit of about kr. 14 billion expected in 1980.	Nov.	+ 6.0%	Aug.	+ 7.8%	11.00%	.1843	Monetary policy remains restrictive.	Denmark
87	Trade balance slipping into deficit, owing to growing import bill.	Nov.	+ 7.9%	Aug.	+12.9%	8.50%	.2712	Credit conditions tightening somewhat.	Finland
0	Strong exchange rate eroding export-price competitiveness.	Dec.	+11.8%	Dec. '78	+12.4%	9.50%	.2459	Credit demands keep short-term rates high.	France
0	Current-account gap expected to widen substantially this year.	Dec.	+ 5.4%	Sept.	+12.7%	6.00%	.5753	Bundesbank announces lower 1980 monetary target.	Germany
0	Higher oil prices weaken balance of payments.	Aug.	+13.6%	Aug.	+39.0%	13.70%	2.1330	Credit conditions restrictive; interest rates in 18% range.	Ireland
0	Large current-account surplus in 1979, but shrinkage expected in 1980.	Dec.	+19.8%	Apr.	+14.8%	15.00%	.001239	Discount rate raised to 15% in December.	Italy
0	Gas export prices being renegotiated, but energy deficit likely to persist.	Nov.	+ 4.6%	Sept.	+16.6%	10.25%	.5205	Monetary conditions continue restrictive.	Netherlands
0	Narrowing of last year's kr. 7-billion deficit anticipated.	Nov.	+ 4.6%	July	+18.4%	9.00%	.2040	Credit tightened; discount rate raised from 7% to 9%.	Norway
24	Improving payments trend of 1979 threatened by higher oil prices.	Oct.	+23.1%	July	+18.7%	17.00%	.0208	Discount rate reduced despite large budget deficit.	Portugal
59	Current account to move into deficit this year.	Oct.	+15.6%	Sept.	+15.9%	8.00%	.0153	Monetary conditions remain restrictive.	Spain
0	Estimates of kr. 3.5-billion deficit for 1979 after kr. 4.7-billion surplus in 1978.	Nov.	+ 9.5%	Sept.	+22.8%	10.00%	.2398	Discount rate boosted from 9% to 10% in January.	Sweden
0	Strong import growth eroding current-account surplus.	Dec.	+ 5.2%	Sept.	+13.8%	2.00%	.6161	Liquidity remains tight in support of exchange rate.	Switzerland
42	Lira devalued from 47.1 to 70 per U.S. dollar.	Nov.	+74.6%	Dec. '78	+26.1%	10.75%	.0145	Monetary aggregate expansion below inflation rate.	Turkey
0	Surplus in merchandise trade boosts exchange rate.	Dec.	+ 9.8%	Aug.	+25.0%	14.00%	.8608	Central bank lowers money-supply growth target.	Canada
0	Current-account balance remains strong.	Dec.	+13.3%	Dec.	+11.4%	12.00%	—	Bond yields rise sharply.	United States

World Interest Rates

market rates of January 30, 1980; bond yields as of January 25, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.50	9.50	6.00	15.00 penalty rate 18.00	9.50*	2.00	6.25
Day-to-Day Money	13.50 Jan. 31	15.00	17.75	10.35	12.125	7.50	16.00	10.50*	0.80	8.25
Treasury Bills 91-day, Middle Rates	12.10	13.50	15.8125	14.40 120-day	n. a.	n. a.	14.261	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	13.10 finance paper	13.90 finance paper 15% tax w/h	15.25	10.40 Certified	n. a. Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.10	13.80 15% tax w/h	16.9375	12.75 Certified	not traded	9.40	n. a.	no market	3.25 not traded	no market
Government Bonds Long-term, new and old issues, average yield	11.82	12.50	13.60	11.01 20% tax w/h	11.67	8.19	14.05	9.50*	4.59	8.01
Industrial Bonds prime, long-term, new and old issues, average yield	13.00 Aa Industrials	12.90	14.53	12.88 20% tax w/h	12.91	8.19	14.35	10.41*	5.64	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	15.25	15.00	18.00	15.25	13.10	9.75	20.00	14.50*	4.25	6.50
Bank Time Deposits 3-month	13.25 Cert. of Dep.	13.85 Cert. of Dep.	17.5625	14.45	12.4375	8.65	10.75	11.00* large deposits	5.8125 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.1875	no market	17.6875	no market	12.75	8.375	no market	11.1875	5.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8608	2.2635	.0354	.2459	.5753	.001239	.5205	.6161	.004186
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.625 *P*	3.375 *D*	FLAT	1.625 *P*	6.00 *P*	8.125 *D*	3.00 *P*	8.75 *P*	5.50 *P*

Eurodollar Deposits
(London, interbank, bid) January 31

7-day	15.50
1-month	13.9375
3-month	14.3125
6-month	14.3125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .13
U.S.-Canada Treasury Bills	−1.41
U.S.-Canada Finance Co. Paper	−1.23
Eurodollars-U.K. Local Auth. Deposits	+ .44

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.125
Over 7 yrs.	12.875
DM Bonds	
7 yrs. and under	8.00
Over 7 yrs.	8.00

Gold Price
London afternoon fixing
691.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Jan. 23; bond yields as of Jan. 18.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	13.3 (Dec.)	9.8 (Dec.)	17.2 (Dec.)	11.8 (Dec.)	5.4 (Dec.)	19.8 (Dec.)	5.2 (Dec.)	5.8 (Dec.)
Industrial production*	0.3 (Dec.)	2.3 (Nov.)	3.4 (Nov.)	2.3 (Nov.)	5.9 (Nov.)	6.7 (Nov.)	0.9 (Oct.)	9.9 (Nov.)
Trade balance† *(billions of local currency units)*	−$3.1 (Dec.)	C$5.3 (Nov.)	−£.07 (Dec.)	−FF.77 (Dec.)	DM.80 (Dec.)	−Lit1,480 (Dec.)	−SF.41 (Dec.)	−¥230 (Dec.)
Money supply (M_1)*	5.7 (Dec.)	2.4 (Dec.)	10.9 (Nov.)	11.3 (Oct.)	7.3 (Dec.)	22.2 (June)	1.1 (Oct.)	7.8 (Nov.)
Velocity of money (M_1)*	5.9 (Sept.)	5.2 (Sept.)	−0.2 (June)	11.5 (Sept.)	0.1 (Sept.)	−3.1 (June)	n.a.	−2.2 (Sept.)
Reserves minus gold *($ million, change from previous month)*	+1,349 (Nov.)	+34 (Nov.)	+249 (Nov.)	+661 (Oct.)	−3,445 (Nov.)	−44 (Nov.)	+562 (Nov.)	−3,120 (Nov.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

The Link Between U.S. and Canadian Policy

The link between the U.S. and Canadian economies is widely acknowledged but broader than most observers realize. The uniquely close relationship of the U.S. and Canadian dollars in foreign-exchange markets is a well-known manifestation of the linkage. Less obvious, perhaps, is the convergence of economic policy that this currency relationship forces upon the two economies.

The essence of the U.S. and Canadian dollar relationship is the high degree of substitutability of the two currencies, which in turn stems from several factors: Both currencies are used interchangeably in Canada and along the northern tier of the United States; U.S. and Canadian monetary and political authorities function similarly; and the capital and product markets of both economies are well-integrated.

This relationship has led to the charge by some that, given the preeminence of the U.S. economy, Canadian economic policy is dictated in Washington. It is perhaps more accurate to say the relationship demands that both economies have similar long-run monetary and fiscal policies. Thus, it is difficult for Canadian authorities to pursue interest-rate and exchange-rate policies significantly different from those of the United States. Indeed, if Canadian policymakers decide to follow divergent long-term economic policies, evidence indicates that the cost of doing so is extremely high.

To see how the relationship reveals itself, it is useful to review briefly the interaction of interest rates, exchange rates, and money growth, which is well-documented in economic theory. Briefly, if the monetary authorities in a country boost interest rates unilaterally, money growth will be restricted and the forward-exchange premium on the country's currency will be raised as a result of arbitrage. (If the foreign-exchange market is convinced that the low money growth will hold, the currency will strengthen in the spot market.) By the same token, a change in *expectations* about money growth (and inflation) will tend to affect the exchange rate and interest rate. For example, if a shock—such as sharply higher oil prices—triggers expectations of a weaker currency and higher inflation, then the forward-exchange market would reflect this expectation. Subsequently, either interest rates or the spot exchange rate—depending upon whether either variable was fixed by official policy—would adjust to the shift in expectations through the opportunities presented by arbitrage.

The interaction of these market forces is heightened by the special relationship between the U.S. and Canadian currencies and by the integration of their capital markets. Although the relationship is not one of *perfect* substitutability—in which interest and inflation rates would have to be the same and the spot exchange rate fixed—the high degree of substitutability still demands that the monetary policies of the two countries converge. For example, if Canada were to pursue a more expansionary policy than the United States, the currency substitution phenomenon would mean that Americans would also borrow Canadian dollars. This would not affect the exchange market, however, since market participants (in the United States and Canada) would continue to accept Canadian dollars in lieu of U.S. dollars with the anticipation of an eventual change in Canadian policy to conform with that of the United States. Thus, the substitutability actually helps delay the exchange-rate effects of divergent policy. But if expectations suddenly change so that the market comes to believe that Canadian policy will *continue* to diverge, then the demand for Canadian dollars would fall and their exchange value would drop sharply.

The point can best be illustrated by the recent behavior of these market variables. Following the November 1978 U.S. actions to support the American dollar, the Canadian currency gained, not lost, ground against the newly strengthened U.S. dollar. This is because the markets *expected—and soon got*—a similar Canadian policy package. Indeed, no loss of Canadian dollar value was needed, as expectations buoyed the Canadian dollar until the response came.

A second illustration is perhaps more interesting. On October 6, 1979, the United States assembled another dollar-support package. The Canadian dollar's value exceeded US$0.85 at the time. For four days the rate held fairly steady. But then the market became concerned about a possible reluctance on the part of the Canadian authorities to match the U.S. interest rate moves. This triggered a sharp drop in the Canadian currency's value. It rebounded after the Canadian authorities introduced a similar policy formula, but the bounce-back took longer since some of the market's confidence in the Canadian authorities' responsiveness was eroded.

In sum, it appears that any effort on the part of the Canadian authorities to diverge permanently from an interest-rate policy followed by the United States will lead not to mild or gradual depreciation or appreciation, but rather to sharp movements in the Canadian currency's value. Brief divergences in interest-rate policy, however, are tolerated, and even accommodated, by the exchange market as the capital markets—owing to currency substitutability—absorb potential exchange-rate pressures. The market thus serves as a stern taskmaster, demanding, in the long run, that Canadian and U.S. policymakers follow similar paths, but forgiving short-run divergences.

D. Sykes Wilford

The Eurodollar—CD Difference

The links between the external Eurodollar market and the domestic U.S. money market are extremely close. But the persistence of a large interest-rate differential between Eurodollar deposits and domestic certificates of deposit (CDs) of similar maturities raises some perplexing questions: Why is arbitrage unable to eliminate the differential between these two closely linked markets? More specifically, why do some U.S. depositors choose CDs, shunning higher returns on Eurodollar deposits?

The answers to these questions require a look at both sides of the balance sheet of banks operating in both the U.S. money market and in the Eurodollar market. On the lending side, any loan made by a bank, whether booked in the Euromarket or domestically, must be funded. The economics of liability management suggests that banks seek the cheaper source of funds. In the Eurodollar market there are no reserve requirements or other government-imposed taxes. The interest rate, therefore, reflects the marginal cost of funding in this market. In the domestic money market, the marginal cost of funding is not fully reflected in the interest rate. Indeed, reserve requirements and deposit insurance raise the marginal cost of funding by about 1.08 times the interest rate on certificates of deposit. Banks are willing to offer a higher rate of return on Eurodollar deposits than for domestic CDs. And they will do so until the funding costs in the two markets are equalized.

On the other side of the market are the depositors, or the suppliers of bank liabilities. Depositors are generally assumed to adjust their portfolios until the risk-adjusted rates of return on the assets they hold are equal. Nevertheless, 90-day domestic CDs consistently offer rates of return that are 8⅞-9⅞ (or currently between 100 and 125 basis points) less than 90-day Eurodollar deposits.

The willingness of some depositors to settle for less can be explained by several theories. One, depositors may be segmented into two groups—those inclined to invest in Eurodollar deposits and those interested only in domestic money-market investments. The latter group of domestic borrowers may lack the sophistication to tap investment opportunities in the external market, or may be constrained by internal policies or institutional reasons. A second theory is that a substantial group of investors perceives differences in risk between the two types of deposits. Since Eurodollar deposits are held in a foreign country, there is concern about capital controls, tax levies, or even political turmoil—risks that are virtually nonexistent in the domestic market. Finally, transactions costs in the Eurodollar market may be greater for U.S. depositholders than costs in the domestic CD market because of time-zone differentials and associated delivery risks.

For whatever reason, depositors are apparently willing to accept and sustain a difference in yields. And the persistence of a yield differential that seems to reflect almost precisely the cost of reserve requirements in the domestic market implies that the *banks* are the dominant arbitragers in the market. That is, depositors —who do not *all* arbitrage—might be willing to accept even higher yield differentials. Banks, however, in the process of equalizing funding costs, force the differential to correspond to their differing costs in the two markets.

Bluford H. Putnam

Eurocurrency Market

(billion $, end of period)

	IQ/79	IIQ/79	IIIQ/79	IVQ/79	1978	1979 (est.)	1980 (est.)
Total Market Size							
Gross Size (Claims)	883.9	946.5	1,025.0	1,100.0	892.1	1,100.0	1,350.0
Net Size (Claims)	550.0	585.0	625.0	670.0	535.0	670.0	820.0
Liabilities to Private Nonbanks	145.0	155.0	162.0	170.0	140.0	170.0	210.0
Claims on Foreign Nonbanks	285.0	295.0	307.0	320.0	280.0	320.0	365.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	273.5	297.0	324.3	335.0	259.9	335.0	400.0
Liabilities to Private Nonbank Foreigners	57.8	60.7	65.4	72.0	57.8	72.0	87.0
Total Claims on Foreigners	278.4	293.0	316.5	325.0	281.5	325.0	405.0
Claims on Foreign Public Borrowers	35.7	36.1	38.7	40.0	33.8	40.0	55.0
Claims on Foreign Private Nonbank Borrowers	103.5	107.7	113.1	120.0	104.3	120.0	140.0

Note: Gross and *net* Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.